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Delaware Chancery Court Upholds Barnes & Noble's Rights Plan

In the recent decision of *Yucaipa American Alliance Fund II, L.P. v. Riggio et al*, the Delaware Court of Chancery upheld the adoption and use of a rights plan by the board of directors of Barnes & Noble, Inc. as a good faith and reasonable response to a stockholder's rapid open market accumulation of the company's stock. Vice Chancellor Strine held that the familiar two-pronged analysis set forth in *Unocal Corp. v. Mesa Petroleum* was the appropriate standard of review and that the board was reasonable in adopting a 20% trigger rights plan while permitting the company's chairman and his family to maintain an approximately 30% stake, and in refusing to raise the trigger threshold to enable two significant stockholders to jointly run a proxy contest.

Background

In November 2009, investor Ronald Burkle's funds ("Yucaipa") approximately doubled their ownership stake in Barnes & Noble to 17.8% in a period of a few days. The Schedule 13D filed by Yucaipa indicated that it reserved the right to take several actions, including M&A transactions. In response to the rapid accumulation of stock, the board of Barnes & Noble met with its advisors and quickly adopted a 20% trigger rights plan that also restricted stockholders who together beneficially owned more than 20% of the company from jointly running and funding a proxy contest. The rights plan permitted Leonard Riggio, the founder and chairman of the board of Barnes & Noble, to maintain his existing approximately 30% stake in the company but restricted him from acquiring additional stock. In response, Yucaipa demanded the board provide an exception to Yucaipa under the rights plan to permit it to acquire up to 37% of the stock (representing the total voting power of the Riggios, the rest of the board and stockholding employees). When the board rejected this request, Yucaipa filed a lawsuit claiming breach of fiduciary duty and later moved for expedited proceedings claiming that the rights plan impeded its ability to run a proxy contest for the 2010 annual meeting. In addition, over the same time period, another stockholder who often followed Yucaipa's investment strategies and with whom Burkle had discussions during that time, Alethia Research and Management, Inc. ("Alethia"), tripled its stake in the company to 17.4% of the stock.

Standard of Review

Yucaipa alleged that the appropriate standard of review was either the "entire fairness review" or the *Blasius* standard of "compelling justification". The Court rejected this argument. It held that the grandfathering by the rights plan of Riggio's existing stake did not mean that Riggio was on both sides of the negotiation and therefore the "entire fairness review" standard did not apply. The Court noted that the plan did not provide a special benefit to Riggio but rather subjected Riggio to a new limitation as it restricted him from acquiring additional stock, except in very limited circumstances. In

rejecting the *Blasius* standard, the Court held that the board's primary intention was not to disenfranchise Barnes & Noble's stockholders, but the board was instead trying to create leverage so that Yucaipa would not acquire control without paying a fair premium to the rest of the stockholders. The Court concluded that, pursuant to the precedent in *Moran v. Household International Inc.*, the *Unocal* standard applied in determining whether a board's adoption of a rights plan complied with its fiduciary duties and in analyzing the effect of poison pills and other defenses on the ability of stockholders to conduct proxy contests.

Analysis under *Unocal*

Under *Unocal*, in order to receive the benefit of the business judgment rule, directors adopting a defensive measure must first demonstrate that they had reasonable grounds for concluding that a threat to "corporate policy and effectiveness" existed, and then must establish that their defensive response was neither preclusive nor coercive and was reasonable in relation to the threat posed.

Yucaipa admitted that the rights plan was adopted in response to a legitimate threat caused by the rapid accumulation of stock by Yucaipa and Alethia and the statements in their respective Schedules 13D that reserved the right to take "extraordinary corporate transaction[s]". However, Yucaipa claimed that once the initial threat subsided, the plan did not fall within "the range of reasonableness" because (1) the beneficial ownership provision in the plan was ambiguous and (2) the plan was not proportional to the threat faced by the company.

The Court dismissed Yucaipa's assertion that the plan was ambiguous and should not be read as to prevent Yucaipa from jointly running a proxy contest with other stockholders, such as Alethia. The Court noted that the plan's beneficial ownership language has been used in "countless plans" and was clear, and that in other cases involving plans having substantively identical language to the plan here, including *Moran*, courts have understood that the language prevents stockholders from reaching agreement regarding jointly running a proxy contest if their combined interest exceeded the trigger percentage. Likewise, the Court noted that the language in the plan was similar to many other plans that have been upheld by the courts on the basis that they did not prevent stockholders from soliciting and receiving revocable proxies in a proxy contest.

Finally, the Court rejected Yucaipa's claim that Riggio's approximately 30% stake in the company coupled with the rights plan disproportionately disfavored Yucaipa in a proxy contest and that it was unreasonable for the board not to increase the threshold for Yucaipa to 37%. Although the Court acknowledged that the Barnes & Noble board's process of deliberating the threat posed by Yucaipa was not ideal in that there was no independent committee and Riggio participated in the discussions, it concluded that overall, the board acted in the best interests of the company and the stockholders. It held that the rights plan was neither preclusive nor coercive because it was "realistically possible" for Yucaipa to win a proxy contest, even in conjunction with Riggio's existing stake and Barnes & Noble's other defensive mechanisms, in particular, its staggered board. The Court also considered the fact that the rights plan would be subject to a stockholder vote at the end of the year in determining that it was not preclusive. Furthermore, the Court stated that Riggio's existing stake did not undermine the reasonableness of the board's concern about the threat posed by Yucaipa and noted that the restrictions in the rights plan, including on Riggio, prevented the acceleration of an open market purchase contest among Riggio, Yucaipa and Alethia that may result in the remaining stockholders becoming a minority

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without sharing in a control premium. The Court added that notwithstanding Yucaipa's claims that the initial threat subsided and it was therefore unreasonable for the Barnes & Noble board not to increase the trigger threshold, Yucaipa continued to pose a threat to the company even after the adoption of the plan – Yucaipa had a high possibility of winning a proxy contest, it continued to criticize the board and to tout strategic options for the future of the company, and it was likely that it could, together with another significant stockholder, acquire control of the company without paying a fair premium to the rest of the stockholders.

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